

# Summary introduction to Economics and Business Economics

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# Lecture 1 Introduction

**Opportunity costs** -> for every choice there is a cost, the “net worth” of your second choice. You sacrifice something to do another thing (time or money). So, time is money.

when taking an action implies forgoing the next best alternative action, this is the net benefit of the foregone alternative. -> When we consider the cost of taking action A we include the fact that if we do A, we cannot do B. so, not doing B becomes part of the cost of doing A.

**Opportunity costs** -> implicit costs (value -explicit costs)

**Explicit costs** -> out-of-pocket costs, (what does it actually cost)

**Economic costs** -> Explicit + Implicit

**Economic rents** -> value – Economic costs

**Implicit costs** -> value 2<sup>nd</sup> choice – explicit costs 2<sup>nd</sup> choice. (what do I give up) -> opportunity cost

**Value** -> how to measure

**Sunk cost** -> you can't change anymore we experience them as losses. Sometimes you can recover a part of the costs then it is part of the explicit costs.

**Economic growth** -> an increase in the production of economic goods and services, compared from one period of time to another. Is caused by productivity growth.

- How badly do we want things? Not objective value, because the value is different for everybody. You can't measure it but you want it when there is no economic growth = crisis/recession.

## Why does productivity grow?

- We work less but we still manage to increase welfare.
- Private property rights.
- Markets: trade & exchange -> facilitate specialisation
- Price steer behavior: what is produced? By who? How is it produced? How much is produced? Who gets it?
- Companies: investment, economies of scale & technology.

We are all incentivized to behave efficiently and productively, do you need incentives? People make a trade-off between their individual costs and benefits. -> made these choices rational and optimizing. Governments use laws, rules, and, incentives to influence our choices.

**Scarcity** -> makes us make choices, for us mostly time & money. Describes how the availability of supplies, raw materials, or employees is crucial to producing goods and services and setting their prices.

**Marginal analysis:  $MR = MC$**  -> marginal returns = marginal costs.

- Marginal returns/ benefits = what is the return/benefit of one extra unit?
- Marginal costs = what are the costs of one extra unit?
- Diminishing/ increasing marginal costs/benefits. Opportunity costs should be taken into account.
- Marginal profit =  $MR - MC$

If  $MR > MC$  -> the firm could increase profit by raising Q

If  $MR < MC$  -> the marginal profit is negative, it would be better to decrease Q

If  $MR = MC$  -> profit reaches a maximum.

## Lecture 2 Specialization, Trade & Exchange

**Incentives** -> good/ bad behavior -> have also unintended consequences.

- Prices, taxes, subsidies, and, nudges
- Bonuses (your boss doesn't trust you)
- Mortgage deduction & pension savings

Inheritance taxes-> economics love it because it doesn't affect our behavior (negatively).

**GDP** -> The size of the economy is measured by GDP. The value added in an economy in a certain period of time (far from perfect)

**GDP per capita** -> per person, when you need to make it relative.

**Economic growth** -> growth GDP per capita, also productivity growth, that leads to long-term growth. Now we're becoming less productive -> social media -> productivity growth is going down.

the more we are **specialized** the richer we will be. In a market economy, nobody is "self-sufficient".

- Productivity is increased when we specialize or specialize where we are relatively good at. -> also known as the lowest opportunity costs.

Increase in average productivity due to (re) allocation, when we specialize -> everyone produces more & less than necessary as a result. This is only possible if the "surplus" can be sold on the market and the "shortage" bought.

More trade in market -> more specialization -> higher the average productivity -> higher the wealth.

The gains from specialization -> We become better at producing things when we each focus on a limited range of activities:

- Learning by doing
- Difference in ability
- Economies of scale

A firm facilitates a kind of cooperation among specialized producers that increases productivity.

Markets -> **competition and cooperation** -> results unintended cooperation on a global scale.

- Markets contribute to increasing the productivity of Labor -> by allowing people to specialize in the production of goods for which they have a comparative advantage, that is the thing at which they are relatively speaking the least bad at.

**Production possibilities frontier** -> how much can a company produce?

- Constant opportunity costs
- Increasing opportunity costs -> maybe more realistic.

**Absolute advantage** -> best in making a certain product.

**Term of trade** -> any price between the internal opportunity costs of both countries.

Example:

Production per hour	Germany	France
Bikes	2	<b>6</b>
Cars	<b>8</b>	2

Germany -> absolute advantage production of cars. -> 1 car = ¼ bike

France -> absolute advantage production of bikes. -> 1 car = 3 bikes

Terms of trade -> potential price -> 1 car = ¾ bike.

**Comparative advantage** -> the good you can produce the cheapest in relative terms. In terms of other goods -> opportunity costs.

Example:

Hours of labor to produce one	Cars	Bikes
Germany	<b>8</b>	<b>2</b>
France	10	5

Opportunity costs for the production of one	Cars	Bikes
Germany	4 bikes	<b>¼ car</b>
France	<b>2 bikes</b>	½ car

Germany -> comparative advantage for making bikes.

France -> comparative advantage for making cars.

Possible terms of trade -> 1 car for 3 bikes (1 bike = 1/3 car)

The more we buy and sell the more we can specialize in the things were at least “suck” at the more we can increase overall productivity the better where all are -> The higher the average standard of living is.

The consequence of free trade:

- Trade leads to specialization
- Because of this: industry actors “win” or “lose”.

**Winners:** everybody involved in the production of goods for which the country does have a comparative advantage, and everybody else, through lower prices.

**Losers:** everybody involved in the production of goods for which the country does not have a comparative advantage.

**Markets** -> trade & exchange -> specialization -> average productivity goes up -> higher GDP

- Buyers -> only demand goods if the price is lower or equal to the value-driven from it.
- Sellers -> only supply goods if the price is higher than or equal to the marginal costs of production.

### **Conspicuous consumption & positional externalities**

- Really love a brand
- Showing it to others creates value for a product.

Conspicuous consumption -> You want other people are going to compare it to their situation.

Positional externalities -> type of goods for which happiness obtained from it does not only come from that consumption but relative to others.

High debts -> high saving pots -> large financial sector -> lot of vulnerability.

There are some basic “assumptions” concerning (perfectly) competitive markets:

- There must be “many” buyers and sellers
- There is free entry and exit
- No one is powerful enough to influence prices (price takers)
- Goods are homogeneous
- Every buyer and seller has “perfect information”
- Everyone acts rationally and optimizing
- Everyone only acts if it is in his/her favor
- Markets function in “isolation”
- Criticism: what if these assumptions are (partially) incorrect?

**Capitalism** -> economic system characterized by a particular combination of institutions.

**Economic system** -> way of organizing the production and distribution of goods and services in an entire economy.

**Capitalist system** -> production takes place in firms.

- Inputs and outputs are private property
- Firms use markets to sell outputs.

**Distinctive aspect of capitalism as an economic system:**

- Most production takes place using privately owned capital goods that are operated by workers who are paid wages.

**Major changes accompanied the emergence of capitalism:**

- Technology
- Specialization

**Labor market** -> employers (demand side) offer wages to individuals (the employees -> supply side) who may agree to work under their conditions.

## Lecture 3 Markets

**Demand side** -> total willingness to pay for a product.

**Law of demand: Ceteris paribus** (returns/benefits)

- The quantity demanded of goods decreases as the price rises -> almost always true for total demand.

**Change in quantity demanded** = price change -> changes over the curve.

**Change in demand** = independently of a price change -> shift of the demand curve.

- Demand curve to the left -> less demand by a certain price (decrease).
- Demand curve to the right -> more demand by a certain price (increase).

**Elasticity** -> how sensitive is the quantity demanded for a price change.

- Price elastic -> sensitive quantity of demand.
- Price inelastic -> not the sensitive quantity of demand.

**Price discounts** on products that are price elastic and not on products that are inelastic. The same holds for **taxes** but the opposite, the government tax product that is inelastic and not products that are elastic. In this way are the products still bought as much even if the price is higher.

If demand changes independent from a change in prices, the whole demand curve shifts:

- Prices of related goods
  - **Substitution goods** -> choosing another good
  - **Complementary goods** -> related good
- Income
  - Normal goods
  - Inferior goods
- Preferences -> Taste, hypes, fashion, marketing, technology, etc.
- Size of the market
- **Expectations** about the future (prices)

**Supply-side** -> total willingness to accept of individual sellers.

Individual -> "willingness to accept" -> marginal costs.

**Law of supply -> Ceteris paribus**

- The quantity supplied of a good increase as the price rises.

**Change in quantity supplied** = price change -> change over the curve.

**Change in supply** = independently of a price change -> shift of the supply curve.

- Supply curve to the left (goes up)-> less supply by a certain price. (price up)
- Supply curve to the right (goes down) -> more supply by a certain price. (price down)

### Change in supply without a change in price -> causes:

- Profitability alternative products (opportunity costs)
- Technology/Productivity
- Amount of suppliers
- Taxes & subsidies
- The costs of resources
- **Expectations** about the future (prices) -> influencing prices.

**Platform economy** -> every new customer is cheaper than the last one.

Supply > demand -> price goes down.

Supply < demand -> price goes up.

**Equilibrium** -> demand = supply

- In the equilibrium, everybody who values the product more than the price, can buy the product.
- In the equilibrium, everybody who can produce the product for lower marginal costs than the price, can sell it.

### Welfare:

- Consumers surplus -> difference between the price people are willing to pay, and the price they have to pay.
- Producers surplus -> the difference between the minimum price firms want to receive, and the price they receive.
- Government surplus -> tax income

### Shocks in economic analysis

- Is called exogenous, because our model doesn't explain why it happened: the model shows the consequences, not the causes.

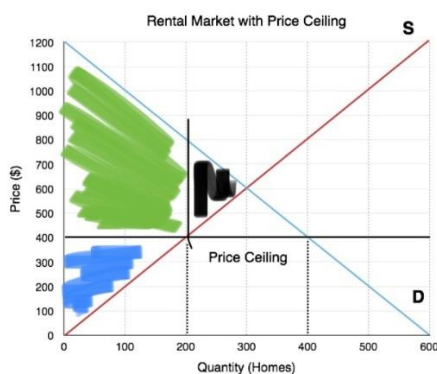
### Government interventions for several reasons:

- Income because of Taxes
- Politics
- Inequality
- Market failure & externalities

**Government interventions: -> outcome is redistribution of surplus -> deadweight loss (DWL)**

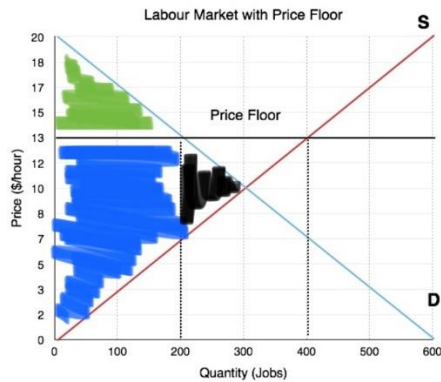
- Price controls (price ceilings or price floors)
- Taxes & subsidies

**Price controls -> price-ceiling (maximum price)**



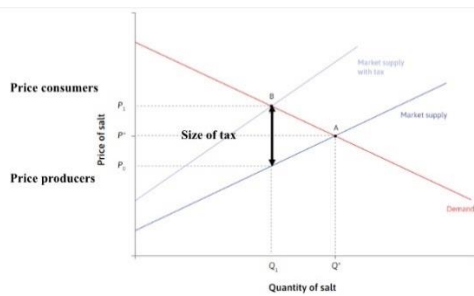
Green -> consumers surplus  
 Blue -> producer's surplus  
 Black-> dead weight loss

Price controls -> price floor (minimum price)

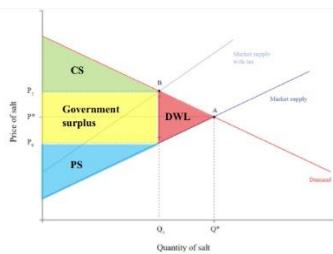


Taxes ->

Because of the taxes the supply curve shifts to the left (goes up), and a firm wants more money for a certain product because of the higher costs. That means that the price goes up -> the demand is getting fewer -> so Q is becoming less.



Company receives -> price – tax  
 Customer pays -> price + tax  
 Government receives -> taxes



The size of the dead weight loss depends on:

- How strongly supply responds to prices.
- How strongly demand responds to prices.

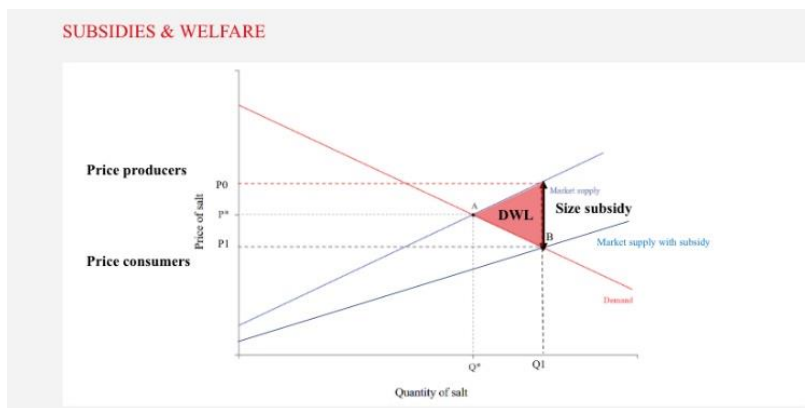




**Subsidies** -> create a loss of wealth because the market no longer reaches its optimal point.

- Choices = individual value consumption – individual costs consumption
- Welfare = value consumption – costs consumption

Subsidy -> part of the costs of consumption shift from private to public. -> This leads to a loss of welfare if people consume something whose value is above the private cost, but not above the total cost.



**market failure:**

In all situations where the free market does not provide an optimal allocation. Why?

- Malfunctioning markets
- Information problems
- Type of product/service

Are goods excludable? -> someone can't use it.

Are goods rivals? -> consumption doesn't exclude consumption from another.

**Free rider problem** -> everybody can make use of it: leads to a socially inefficient outcome.

- Everyone has an incentive not to pay, because of this socially inefficient outcome -> if you left it to the market the products would not be (sufficient) delivered.

Type of goods:

- Private goods (excludable & rival)
- Public goods (non-excludable & non-rival)
- Common goods (rival but not excludable)

Public goods & Common goods: No price

- Externalities  $\diamond$  too high or low consumption

**Externalities:** -> is an indirect cost or benefit to an uninvolved third party that arises as an effect of another party's (or parties) activity.

- People make a trade-off between private costs and revenues. -> sometimes inefficient -> external / social costs.

**Negative externalities:** -> pollution, Axe deo, Photos on social media, and, Schiphol.

**Positive externalities:** -> research, culture, and, we do to little we don't feel the personal benefits.

**Internalise externalities** -> stops climate change.

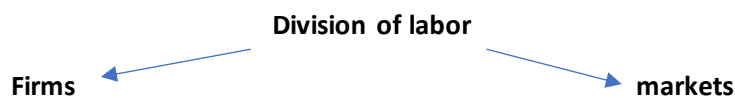
If these products are left to "the market", an inefficient outcome is created:

- Too much consumption with negative externalities.
- Too little consumption with positive externalities.

This is because the decision maker does not / insufficiently takes the external costs & revenues into account

## Lecture 4 The World Economy

**Economics** -> the study of how people interact with each other and with their natural surroundings in producing their livelihoods, and how this change over time.



**Firms** -> concentration of economic power in the hands of the owners and managers -> "order" -> is a command.

**Markets** -> decentralization of power -> purchase and sales results from the buyer and sellers -> "order" -> request for purchase can be rejected if the seller pleases.

**Social interaction markets** -> are typically temporary, in which case this knowledge has little value.

**Owners of firms -> residual claimants (claims the profit)**

In firms, revenues increase because managers and employees do their job well, the owners will benefit, but the managers and employees will not.

**Separation of ownership and control** -> the attribute of some firms by which managers are a separate group from the owners. -> results in a potential conflict of interests -> you can manage this to give stock dividends.

**Firm:**

- Maximizes profits
- Owners have a strong interest in profit maximization: the basis of their wealth.
- Market competition penalizes or eliminates firms that do not make substantial profits for their owners.

# Lecture 5 Markets & Information

We are not self-sufficient

- Consequence -> division of labor & specialization
- 

Division of labor  
Specialization  
Coordination  
Markets & organization (firm)

Government structures:

- How is specialization coordinated?
- How are transactions organized?
- Why in that way?

Input markets -> firm -> Outputs markets

By markets (between companies)

- Relative costs determine the outcome

Within companies

- Managers determine the outcome

Neoclassical 'Theory of the firm'

Neoclassical economics builds theoretical abstract models based on "perfect" markets and "perfect" actors.

A firm:

- Is homogenous.
- Managed by one rational actor who makes all decisions.
- Only has profit maximization as a goal.
- Buys inputs on markets transforms them and sells them.

Consequences:

- Change their strategy if it leads to more profit.
- Investment to do with the highest expected return.

However, if the market is truly perfectly competitive, prices will be equal to marginal costs. So, no firm will be able to make high profits in the long turn when the market is perfectly competitive.

The starting point of neoclassical is behavior on markets.

Some basic institutions are necessary for the existence and functioning of markets.

Humanly devised constraints that structure political, economic, and social interaction.

- Property rights.
- Juridical system.
- Regulations.

What if these institutions differ?

Institutions -> optimal governance structures.

Different institution -> "institutional comparative advantage".

Change of institutions -> change of optimal "governance structures".

**The Standard of living** is based on productivity.  
Productivity is partly based on specialization.  
Specialization is only possible with transactions.  
The number of transactions depends on transaction costs.  
Transaction costs are determined by the institutional environment.  
The institutional environment determines the standard of living.

Coase -> neoclassical economics studies blood circulation and ignores the body.

Production of all goods and services by different actors -> "work together"

Great importance for information:

- One a perfect market: price contains all information necessary.
- What if this is not the case?

Markets -> information -> organizations.

Firms cannot influence prices therefore firms are price takers

Homogeneous goods -> all information is in the price -> prices are a sufficient statistic.

Complete contracts -> information about future development and complete information about the transaction.

Information symmetry -> all actors have access to the same information.

Information is not free, complete, and/or symmetric

- Asymmetric and/ or imperfect information -> market failure
- Market failure: optimal efficiency is not reached.

Solution:

- **Market solve it** -> firms gather, analyze and sell information to others.

Value can only be assessed by revealing the information, but it loses its value. So the market solution to information asymmetry has an information asymmetry problem itself.

**Information asymmetry** -> owners or managers do not always know what their subordinates know.

Information problems can lead to opportunistic behavior

- Seeking self-interest with guile (Williamson)

Actors will try to exploit information asymmetries -> all actors will potentially act opportunistically.

Before a contract is written: **Adverse selection** -> hidden information.

- ➔ In the market for 2<sup>nd</sup> cars, the owner knows how good the cars are but you don't.

**Solutions:**

- Increase observability by screening
- Independent inspections.

After a contract is written: **Moral hazard** -> hidden action.

- ➔ Insurers face this problem, for example, the person with home insurance may take less care to avoid fires or other damages to his home.

**Solutions:**

Information about behavior:

- Monitoring, Black list, and, Collective information sharing

Incentives for good behavior

- Bonuses, own risk premia, discount for not using insurance (no claim)

# Lecture 6 Game Theory

Neoclassical economics:

- We maximize our own utility, which leads to a maximization of the common utility

Criticism **John Nash:**

- Acting in own interest doesn't always serve the common good
- Acting in own interest doesn't always serve your own interest
- Coordination of choices can have a positive effect

**Game theory:**

- Analysing strategic behavior of individuals, firms, governments etc.
- Payoff of player does not only depend on own choices -> how to deal with this?

**Within economics:**

- Pricing strategy, product strategy, location strategy, marketing strategy, negotiation strategy.

**Types of games:**

- cooperative – non-cooperative.
- Simultaneous game – sequential games.
- One-shot games – repeated games.
- Infinite – finite.

**Nash-equilibrium** -> the outcome of the game is then stable.

- ➔ None of the players has the incentive to change their choice -> logic outcome without coordination. Given the choice of the other player(s).

**Prisoners dilemma:**

	not confess player 2	Confess player 2
Not confess player 1	-1, -1	-9, 0
Confess player 1	0, -9	-5, -5

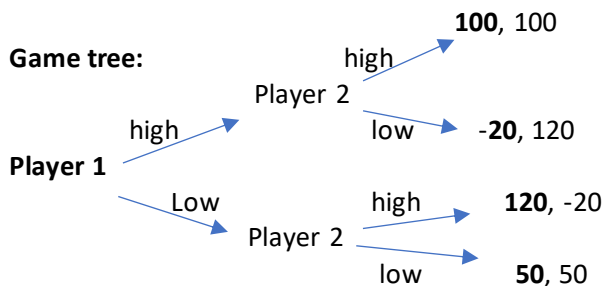
Player 1 chooses not to confess -> player 2 chooses to confess.

Player 1 choose confess -> player 2 choose confess.

Player 2 chooses not to confess -> player 1 chooses to confess

Player 2 choose confess -> player 1 choose confess

**Outcome** -> every actor has the incentive to confess. This is a Nash- equilibrium -> logic to choose confess.



player 1 choose high -> player 2 choose low outcome = -20, 120

player 1 choose low -> player 2 choose low outcome = 50, 50

Nash – equilibrium -> outcome = low, low so, 50,50.

## **Auctions:**

### **Open auction**

- Can be negative for the seller -> sold for less than the value of the product.

### **Sealed bid auction**

- Estimation of opponent's valuation.

### **Dutch auction (top-down)**

- To overcome the loss of the seller

The danger of the **winner curse** for the buyer.

The danger of **collusion** for the seller.

### **Second price auction**

- Winner pays second highest bid -> all should bid real valuation.

### **Ultimate game:**

One player 100 euros -> share with the second player.

The second player may choose to accept or decline the offer

- ➔ The second player declines the offer, both players get nothing.

### **Public goods game**

10 players -> 10 euro each

Each player must choose which part of these 10 euros:

- The player keeps
- The player puts in the collective pot.

When each player has chosen, the collective pot is doubled.

Each player receives the amount that they have kept for themselves + 10% of the collective pot.

## **Lecture 7 Transaction costs Economics**

**Transaction** -> everything a firm buys and sells.

With almost everything a firm does or uses, the firm has to choose: -> make or buy decision.

- Make the input (organization)
- Buy the input on the market.

The firm decides to make -> firm grows.

When using the organization and when the market?

### **Coase: Nature of the firm.**

On market:

- Transactions are coordinated by the price-mechanism

Within firms:

- Transactions are eliminated.

It is not free to use the market -> **transaction costs**, this is the reason why entrepreneurs choose to do things themselves.

Which costs are linked to the use of the price mechanism: **three Cs**

- **Contact** -> costs of finding the right business partner (prices/suppliers/consumers).
- **Contract** -> costs of drawing up and negotiating the contract.
- **Control** -> costs of monitoring behavior, solving conflicts.

These costs influence the optimal governance structure.

Higher transaction costs -> internalization becomes more attractive versus the market.

Firms exist because of transaction costs. The size of the firm is the number of transactions that are internalized. Firms have a maximum size because of internal management costs.

There is not one big firm because of diminishing returns to management -> **internal transaction costs.**

- Decreasing efficiency & increasing management problems.
- Loss of comparative advantages/specialization -> loss of market efficiencies.

The optimal size of firms:

- **Marginal analysis.** -> **MR = MC**

MR = lower transaction costs because of internalization.

MC = higher management costs because of internalization.

**Critical dimensions of transactions** -> transaction costs

- The **frequency** of a transaction -> Due to the frequency of the transaction, one party has an advantage over the alternative market parties, so that in reality there is no longer any real free choice. Less likely (more expensive) to switch to another partner -> that point **"lock in"**. this creates power for one or both parties, making long-term contracts or internalization a logical step.
- **Complexity and uncertainty** -> The more **uncertainty** involved in the production of a good, the more difficult it is to draw up a complete contract. The more **complex** a contract or transaction, the more difficult it is to draw up a complete contract = incomplete contract -> more room for opportunistic behavior. In the case of a complex transaction, production is more likely to be internalized – not bought on the market.
- **Asses specificity** -> The degree to which the transaction needs to be supported by transaction-specific assets. -> you lose it when the contract will be broken. Risk -> one of the actors will act opportunistically (will try to exploit the situation). The more one actor is dependent on the other, the greater the danger of opportunistic behavior.  
**Relationship-specific or firm-specific assets** -> lost their value to both sides when the relationship ends.

With high "asset specificity -> greater risk and costs of opportunistic behavior. -> because of this risk, actors can enter into fewer or no transactions, even though they have a positive economic value -> if this situation arises -> **"Hold-Up"**. The problem is empirical evidence.

Once there is dependence -> people will make use of it -> solution **shares of the company.**

## Sunk costs and Quasi-rents

- Asset-specificity problems occur in the presence of sunk costs and quasi-rents.
- **Quasi-rents** -> the market price above the variable costs.

**Lock-in** -> The choice is not based on **efficiency** but on “**switching costs**”.

**Low transaction costs** (low risk) -> market

**High transaction costs** -> market maybe not be the most optimal governance structure -> hierarchy becomes more feasible.

Institutions -> transaction costs -> optimal governance structure.

The existence of transaction costs mostly depends upon the probability of the opportunistic behavior of one of the actors.

When there is more trust in a society, people expect less opportunistic behavior -> lower transaction costs -> more market transactions.

## Lecture 8 Agency Theory & Corporate Governance

Transaction costs economics models the risk and costs of possible opportunistic behavior on markets -> transaction cost

Agency theory:

- When to expect opportunistic behavior from others?
- How to make sure others don't act opportunistically?
- How does this affect our institutional system?

**Simple form:**

- There is a ( informal ) contract between two actors.

**Principal:**

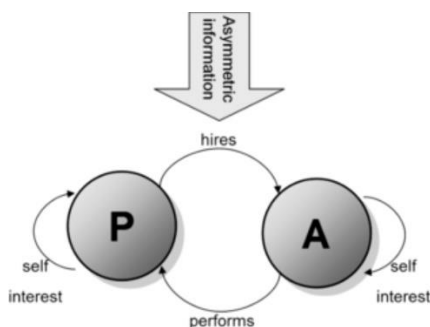
- Transfers responsibilities to an agent.
- Is affected by the behavior of the agent.

**Agent:**

- Receives responsibilities from the principal.
- Choices agent affects the outcome for the principal.

**Two main conditions** -> great risk for opportunistic behavior of the agent.

- The agent has **opposite interests** than the principal.
- There is **information asymmetry** between the principal and the agent.





## Shareholders ↔ Managers

Main assumptions:

- Neoclassical “theory of the firm”: Organization is managed by 1 rational actor.
- Transaction costs economics: The organization internalizes transactions to prevent opportunistic behavior.
- Agency theory: A firm is a nexus of contracts -> the relation between all participants in and outside the firm is based on contracts.

Outcome:

- Every relation within and between firms should be based on contracts and tools to limit the conflict of interests and information asymmetry problems.

Shareholders -> want profit.

Managers -> want money (a good salary)

Shareholders are unable to control all the managers. The problem is especially relevant for small shareholders because it makes no sense for them to control the managers because they get a very small part of the profit.

### Market solutions of conflicting interests

- Market for products, stock market, market for management, market for “corporate control”.

### Bureaucracy solutions: implement market incentives.

- Monitoring effort, behavior, and results.
- Reward results -> incentives for “good behavior”.

### Bonuses:

- Success depends on “incentives”.

Assumption -> financial stimulus -> “better” results.

Standard solution:

- Monitoring -> only works when the results are visible and measurable.
- Measuring the results of commercial firms, is not objective.
- Choices concerning what & how you measure -> incentives -> behavior. ( you create a different kind of behavior -> could lead to undesirable effects. **Performativity**).

## Society ↔ firms/ organizations

Conflict of interest: manage organizations as firms.

Information asymmetry: measure results

Goal -> more efficiency

Problems:

- Public sector is often not faced with competition.
- Public sector is not allowed to default.
- Efficiency/ results are hard to measure.
- Incentive contracts create behavior -> could lead to **undesirable effects**.
- Assumes bad behavior -> actors act opportunistically.

The total costs associated with an agency relationship are the agency costs:

- **Prevention costs (bonding costs)** -> costs of setting boundaries on the possible actions of the agent.
- **Inspection costs (monitoring costs)** -> costs that come from controlling and inspection.
- **Consequences costs** -> costs of loss in welfare because of the difference between decisions agents and potential maximum outcome for principals.

**Corporate governance:** -> the system by which business corporations are directed and controlled.

- minimize agency problems between society and companies.

In large companies -> a separation of ownership and control.

Therefore, a potential conflict of interest & information asymmetry.

Leads to -> agency problem

In society: firms are suppliers, employers, and investments.

- Important that firms act in the interest of society.
- Importance of well-functioning national corporate governance.

**Agency problem -> VOC**

- The shareholders (principals) were insufficiently able to direct and monitor the behavior and results of the managers (agents).

Shareholders activism: shareholders demanded:

- Transparent information
- Right to appoint managers
- Time limits to managers' tenure
- Adjustment of remuneration
- Limits to possibilities for insider trading

**Bubble:**-> agency problem

The main stages in a bubble -> bitcoin, house prices, and tesla.

- Take off -> media attention -> graph goes up and then falls down (the question is when.)

**Agency problem:**

Due to conflicting interests:

- Incentive contracts
- Market solution

Due to information asymmetry

- Internal monitoring
- External monitoring

**Internal:**

- monitoring by shareholders (largest owners)
- free rider problem

**External:**

- monitoring by auditing firms (incentives auditing firms?)
- monitoring by credit rating agencies (incentives credit rating agencies?)
- stock analysts/ news agencies
- Debt holders (banks)

# Lecture 9 The Behavioural Theory of the Firm

**Behavior theory of the firm:** -> How do companies make decisions?

- A firm is viewed as a **coalition of participants** from different actors in the game.
- The firm has no **un-ambiguous objectives**.
- Information is **not free and perfect**.
- Decision makers are **boundedly rational**.

**Organizational goals:**

- The goals of the firm are reached through a bargaining process.
- The **bargaining power** of different participants determines the extent to which certain goals be pursued by the firm.
- The bargaining power of different participants depends upon how unique/ valuable their **contribution** is offered to the coalition and on their **legitimacy**.

Different participants in an organization contribute to the organization (**contributions**) in exchange for rewards (**inducements**).

Offer -> contributions

Want -> inducements

**Everyone has a certain goal in their mind:**

- This goal is the minimum reward they want to receive -> **aspiration levels**.
- Aspiration levels can change over time.
- As long as the reward is higher than this goal, one is satisfied -> **satisficing behavior**.

Satisficing behavior -> reward higher than your goal. -> risk adverse -> leads to insurance companies

**Risk-averse:**

- willingness to accept a less favorable outcome if it is associated with less risk.
- Be willing to pay a premium to incur less risk.

**Loss aversion:** people, hence organizational decision makers, become less risk averse when in a situation they perceive to be a loss.

- Gamblers that lost money
- A student that has failed an exam
- An organization that performs worse than expected/aspired

**Escalation of commitment** -> often known as the **sunk-costs fallacy**

- Is a human behavior pattern in which an individual or group facing increasingly negative outcomes from a decision, action, or investment nevertheless continues the behavior instead of altering course. The actor maintains behaviors that are irrational but align with previous decisions and actions.

Other examples of **cognitive biases** ->

- **Loss Aversion**: Losing is seen as too important
- **Risk aversion**: People want to be over-compensated for risk
- **Escalation of commitment**: Sticking to the decision made in the past even if the face of new information
- **Availability bias/Myopia**: Impact highly visible/recent information instead of probability
- **Anchoring**: Reliance on one piece of (irrelevant) information
- **Gambler's fallacy**: Thinking about chances of future events based on past experience
- **Confirmation bias**: People seek evidence that confirms their beliefs.
- **Ikea effect**: Giving more value to products (partly) created by yourself
- **Hyperbolic discounting**: Present payoffs versus future payoffs
- **In-group bias**: Attributing homogeneous characteristics to people in another group

Behavior theory of the firm sees strategy -> as rather one-dimensional

- Organizations set goals -> evaluate outcomes -> New or old goals

A lot happens in between 'setting the goals' and 'evaluating performance' -> strategy

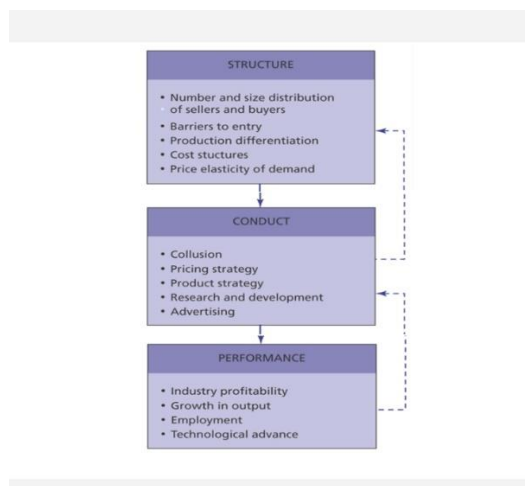
**A competitive strategy**

- Competitive decisions of the business unit in a specific sector.

**A corporate strategy**

- Strategy for the portfolio of business units.

**SCP- PARADIGM**



**Structure** -> market structure would determine firm conduct which would determine performance. Market structure can be measured by a number of factors, such as the number of competitors in an industry, the heterogeneity of products, and the cost of entry and exit.

**Conduct** -> Conduct refers to a number of specific actions taken by a firm, which include price taking, product differentiation, tacit collusion, and exploitation of market power

**Performance** -> Performance of the firm can be measured from a number of indicators such as productive efficiency, allocative efficiency, and profitability

Is there market power?

- Without market power (perfect competition) there is no room for strategy.
- Market power (usually) comes from
- Minimum efficiency scale

**Economies of scale** -> lower production costs per unit.

**Economies of scope** -> two different products are produced more efficiently in one company than in two companies.

## Lecture 10 Competitive & Corporate Strategy

### SCP-PARADIGM & MARKET POWER

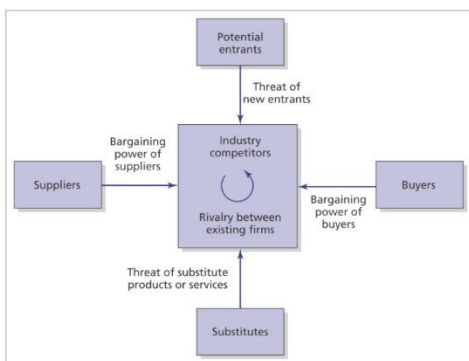
**Market power comes from:**

- Economies of scale/ scope
- Capital -sunk costs / capital investment
- Technology
- Network effects

**Market power** can be used against us -> firms can differentiate their products -> we know those companies because they have market power.

What are the implications of market power?

- Firm & product differentiation
- Price strategies
- Innovation & Marketing
- But also possible collusion and (price)cartels



**Strategic dimensions** are the key variables that can differentiate firm behavior:

- Price
- Quality
- Design
- Service Level

Groups of firms following the same strategic behavior are called **strategic groups**.

- E.g. price-fighters in the airline industry, fast-food chains in the restaurant industry, Mass produced beer in the beer industry.

Does competition happen within the industry or within the strategic group?

**Two generic strategies:**

- **Cost leadership:** The Goal is to have the lowest costs -> large-scale production, homogenous
- **Product differentiation:** Brands, tastes, preferences, heterogenous, innovative.

Any competitive advantage has to come from the possession or access to certain resources that generate a competitive advantage.

- Resource has to be interpreted broadly.

Characteristics of **sustainable competitive advantage** and therefore superior results:

- Valuable
- Rare
- Inimitable (hard to imitate)
- Non-substitutable

Over time the **competitive advantage** that comes from a certain resource may disappear-> technology, taste, and the environment.

- How good is a company at finding a “new” resource that may serve as a source for a new competitive advantage?
- Dynamic capability: “Capacity of an organization to purposefully create, extend or modify its resource base”.
- Some firms may be much better at adapting to new technologies.

Game theory -> takes into account what the other party wants to do.

**Credible commitment:**

- Making a choice that cannot change anymore -> you throw away all your flexibility.

When you are flexible you can be pushed away. When you are not flexible you cannot move so, no one can make you move -> you limit yourself -> you capture yourself.

Sometimes companies do stuff that don't make sense in the short run, but for the protection of the market.

**Profit maximization** (in the short run) is not always the smartest move

- Being flexible is not always a smart move.

### First mover (dis) advantage:

- Network effects
- Fast seconds strategy (Innovate vs Imitate, Exploration versus Exploitation)

### Moving lessons:

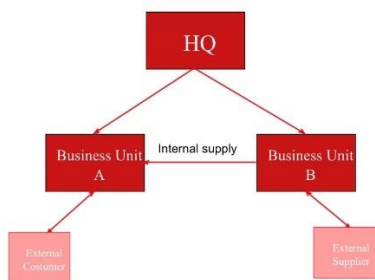
- Firms may deter entry by taking demand (capturing the market)
- Firms may deter entry by credible commitment -> large investment.
- Moving first can be but is not always a strategic advantage.

A **competitive strategy** -> Competitive business unit decisions in a specific sector.

A **corporate strategy** -> Strategy for the **portfolio of business units**.

### Vertical integration ->

- You integrate parts of the production process in your firm.

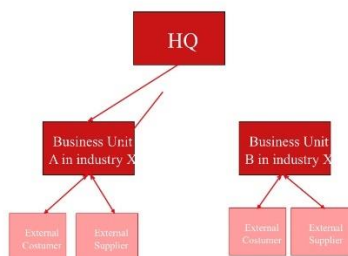


### Benefits:

- All benefits of unrelated diversification.
- Integration of a (part of the) supply chain in one firm -> transaction costs economics.

### Horizontal integration ->

- In the same company two brands are each other competitors.

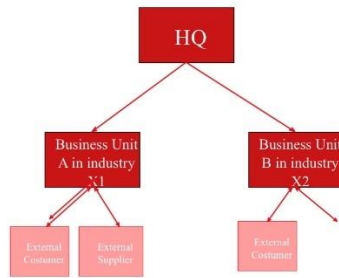


### Benefits:

- All benefits of unrelated diversification
- **Economies of scale** -> lower production costs per unit. Often has to do with capital, technology, and networks.

### Related diversification ->

- It's related but there are some differences. There is something that both business units need.

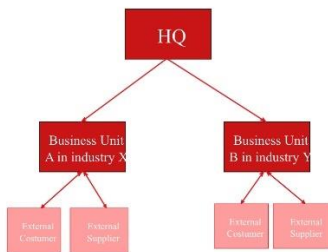


### Benefits:

- All benefits of unrelated diversification
- **Economies of scope** -> two different products are produced more efficiently in one company than in two companies.  $(1 + 1 > 2)$

### Unrelated diversification ->

- Has nothing to do with each other.



### The advantage of unrelated diversification:

- Attracting capital is easier.
- Allocating capital better.
- Lower information asymmetries.
- Conglomerates are on a downturn because analysts often lack the knowledge to assess them properly.
- Conglomerates might be the result of relatively high transaction costs in the market.

## Lecture 11 Mergers, Acquisitions & FDI

Firm growth -> **mergers and acquisitions** -> a firm buys another firm or corporate with it.

How two firms can become one firm ->

- Merger -> two firms become legally one firm.
- Acquisition -> one firm buys another firm out.



**Consolidated industry** -> industry where is not very much growth in it.

**Cashflow-income** -> then you start buying each other, that's the only way to grow.

### Why become one big firm?

- Goal: the combination is worth more than the sum of the companies.  $(1+1>2)$

This means:

- Weighting outflow (acquisition price & integration costs.)
- Versus future inflow (cash flow of acquired company plus any synergies.)

Difficulty -> Determine what exactly are the outflows and synergies.

**Synergy** -> The potential financial benefit achieved through the combining of companies is often a driving force behind a merger.

**Economies of scale** -> the cost price per unit output will decrease because the larger "new" firm has a scale advantage.

### **Economies of scope -> synergy**

- Two different products are produced more efficiently in one company than in two companies.  $(1+1>2)$

### **Economies of vertical integration**

- Can lead to lower transaction costs.
- Integrated into one firm because of fear of possible opportunistic behavior.

### **Reasons become one firm:**

- Market power
- Diversification of portfolio
- Technology (seeking or exploiting)
- Natural resources (seeking or exploiting)
- Access to markets
- Size = (political)power

### How to become one firm?

- **Cash transaction** -> The offer acquiring company of cash for shares by shareholders in the target company. -> high risk.
- **Share transaction** -> The offer by acquiring company of shares or a combination of cash and shares to the target company's shareholders. -> low risk.

### **You buy:**

- Cash transaction -> Think it is going to work.
- Share transaction -> Think it is not going to work.

### **You sell:**

- Cash transaction -> Think it is not going to work.
- Share transaction -> Think it is going to work.

### **Premium:**

- The offered price (cash or shares) is often higher than the current price/value of the shares.

The “extra” amount paid is called the premium.

The moment you know someone is going to offer

- You going to buy shares from that company as an outsider.

Shareholders of buying company are not the happy ones but the seller of the company.

Why can you better be sold than bought?

- **The hope for the premium, then the value of the shares goes up.**

### **Success or failure?**

- Goal is to create “Synergy ” advantages

Synergy -> profitability, growth, market power -> share price.

When is a merger/acquisition successful?

Results:

- 10-15% successful
- 50-65% unsuccessful
- 10-15% disastrous

Why so bad?

- Cost underestimated; revenues overestimated (integration costs)
- Hidden information/adverse selection (Lemons problem)
- Hidden action (Moral hazard)
- Winner's curse: Too optimistic purchase price
- Cultural differences! (integration costs)
- Icarus paradox

**FDI** -> Foreign Direct Investment: Investments from a country in a company in another country, with at least 10% ownership.

### **Types FDI:**

- Horizontal FDI
- Vertical FDI
- Export platform FDI

### **Main motives for FDI:**

- **Factor Costs:** lower production cost (vertical).
- **Market Seeking:** (better) Access to a market (horizontal) -> in addition: Technology & Natural resource seeking or exploiting FDI

### **Melitz model:**

- It is expensive to be an exporter.
- You compete with local firms with home advantage.
- Outcome: only the more productive firms can become exporters.
  
- It is even more expensive to be a multinational.
- Local firms still have the home advantage.
- Outcome: only the most productive firms can become multinationals.
- Therefore: every multinational has something special

### **Horizontal FDI ->**

- Duplicate your activities in another country, in order to sell your products abroad.

Another market can be served by:

- Exports or FDI (local production).

The choice depends on:

- Tradability of good/service
- Transportation costs
- Trade barriers
- Market size
- Fixed costs of export versus FDI
- Plant-level versus firm-level economies of scale

### **Vertical FDI ->**

Fragment different parts production process in different countries.

- Making use of different comparative advantages.
- Making use of factor costs differences
- Making use of factor intensity differences.

“Simple” choice depends on:

- Differences in costs of resources (factor costs)
- Differences in “factor intensity” in different stages of the production process.
- Trade barriers
- Transportation costs

But why would you want to own a foreign company instead of using outsourcing?

- Asset specificity & transaction costs
- Agency costs

### **Why FDI?**

- Firm has to have or need something before FDI makes sense:

### **OLI paradigm:**

- Ownership -> Firm has something it can exploit.
- Location has something to offer.
- Internalization -> fear of behavior supplier/ customer (transaction costs economics & agency theory)

### **The potential effect of FDI:**

- Product market & factor market effects
- Employment & wages
- **Spillovers:** the (free) effect of the actions of some on others.

Why multinationals have to be more productive:

- Spillovers: domestic firms become more productive because of the presence of foreign firms.
- Pecuniary spillovers: spillovers that occur through the price/market mechanism -> same sector and Upstream/downstream.
- Knowledge spillovers: spillovers that occur through the spread of knowledge from FDI firms to domestic firms.
- Horizontal spillovers -> imitation/demonstration effects
- Vertical spillovers -> supply/customer linkages
- Worker mobility -> employees moving from one firm to the other

What has this to do with **agglomerations**?

- Knowledge spread via direct contact.

Most valuable information in the word->

- Testing knowledge, you only learn by doing.

Lower taxes -> attacking multinationals

Higher taxes -> on people they do not move so fast to another country.

## **Lecture 12 hybrids & evolutionary approaches**

**Hybrids** -> Not quite a firm but also not quite the market either. Any governance structure that is between the pure market and the full internalization.

- ABNamro + insurance
- Douwe Egberts + Philips

Asset specificity -> risk of using the market.

**Long-term buyer-supplier relations** -> > 1 year and many products (Water, Electricity, Data) instead of using the market for every delivery or producing internally, you draft a long-term contract. Why?

- Legal protection
- Future benefits curb opportunistic behavior
- Reputation effects

**Joint ventures** -> separate legal entity that is owned by (at least) two other companies. Why?

- Risk sharing
- Resource pooling
- Need for local knowledge/assets
- Need for technological knowledge/assets

Difficult to assess the input of the other company -> mostly short-lived, the project has end-date or success results in a buy-out by one of the partners.

**Alliances** -> for reasons very similar to those of a joint venture but less formal. -> you want to work together without too much risk.

- No new legal entity set-up
- So in-between a long-term relationship and a joint venture

**Business groups** -> A group of independent companies bound together by formal (reciprocal shareholding, board interlocks) and/or informal ties (family, friendship). -> mostly in a non-western setting.

- The formal ones are a lot like holding companies.
- The informal ones are almost impossible to track.

**Why business groups?**

- Reducing transaction costs in low-quality institutional settings.
- Political influence
- Shareholder protection
- Consumer Reputation

Comparable to multi-business firm

- More flexible
- Tunneling/propping and fiscal benefits (artificial pricing)

**Franchise** -> contract between the owner of a brand name and a production process (franchisor) and a local businessman/woman (franchisee). Why:

- Resource scarcity
- Administrative efficiency

Why not the market?

- Risk of free-rider behavior, and reputation.

**Informal networks** -> firms bound together by informal relations only.

- Based on trust, friendship, and co-operation

Informal includes relatively formal relations like interlocking directorates.

**Evolutionary approaches -> look at the field of organizations.**

- Focused on the development of organizations' form over time.

**Organizations are human constructs -> collection of routines -> key steps:**

- **Mutation** -> one unit is different from the other unit. (new routines)
- **Selection** -> this different unit survives, and even has certain advantages. (successful in competition)
- **Retention** -> the unit is multiplied, through imitation. (successful routine spreads)

**Key premises: organizations are inert -> Behavior theory of the firm -> evolutionary approaches.**

**Organizations are based on routines**

- Makes them reliable and accountable, routines have to be relatively stable.

Can be changed, but slowly and often with lots of resistance.

Each **"Niche"** (sub Industry/way) has a certain **carrying capacity**.

- Upper limit on the demand for virtually every product/service

This carrying can be filled by many small or a few larger organizations.

- Mutations due to birth, death, growth, and merger.

The balance between these mutation forces and hence the composition of organizations depends on:

- Competition
- Legitimacy

Organizations are composed of routines -> do not change, and are not written down.

**Organization routines are largely tacit:**

- Serve as memories.
- Serve to keep the peace between various stakeholders.
- Again, links back to the Behavioural Theory of the Firm.
- Prevent continuous and repeated battles between different interests in the organization.

Sometimes routines change:

- **Deliberate action** -> innovation
- **Change/randomness** -> innovation

**Evolutionary process:** -> mutation -> selection -> retention.

- Every economic agglomeration can be explained by using these steps.

**Icarus paradox** -> success leads to the demise:

- Overconfident/complacency
- Frame new development as a threat rather than an opportunity.
- NIH syndrome
- Unwilling to cannibalize

A firm will not survive in the future if the firm does not change.

**Two important caveats:**

- As with genes, collectives of routines compete so bad routines can survive.
- No progress towards the ultimate organizational form. Every surviving form is perfectly adapted to its environment.
- Failure to adapt means extinction.

